Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,

Petitioner,

vs.

A. JOSEPH GEIST, Trustee.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF ON BEHALF OF PRUDENCE REALIZATION CORPORATION, PETITIONER

IRVING L. SCHANZER,
Attorney for Prudence Realization Corporation, Petitioner.

CASES CITED

TEXTS

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I

The decisions relied upon by respondent do not support the contention that the New York rule on the parity question is one of contract construction, binding upon a federal court in a bankruptcy proceeding under *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 188. On the contrary, an analysis of the decision in *Pink* v. *Thomas,* 282 N. Y. 10, 24 N. E. (2d) 724, principally relied on, demonstrates that the rule is merely an equitable rule for the distribution of insolvent estates in New York and as such is not binding on the bankruptcy courts. *Pink* v. *Thomas, supra,* shows clearly that the New York rule does not depend for its application upon the intention of the parties as expressed in the agreement, but is an "equitable" rule applied where the agreement itself is

actually silent as to intention and even where there is no other evidence whatsoever to show actual intent of the parties. Moreover, the court there also stated that it would reach the conclusion that the guarantor's certificates were subordinate unless the language of the agreement was so clear and unmistakable that the courts would be "compelled" to give effect to the intent of the parties as expressed in the writing. On that basis it is inconceivable that by its reference to the debtor-creditor relationship created by the extraneous guaranty agreement the court may be deemed to have "construed" the certificate.

A more reasonable analysis of the New York rule and one which will coincide with the rationale of the decision in *Pink* v. *Thomas, supra*, is that the court assumes a "special equity" to exist in favor of certificate holders other than the guarantor because of the debtor-creditor relationship existing solely by virtue of the guaranty obligation, and that such "special equity" requires the granting of priority in distribution of the proceeds of the insufficient security.

Described by the New York court as "an equitable rule" (*Pink* v. *Thomas, supra*, 282 N. Y. at pp. 12, 13, 24 N. E. [2d] at p. 725), the New York courts do not consider that they are required to construe the specific language of the certificate as constituting an agreement that the guarantor's certificates are subordinate. The language of the certificates is referred to in the New York cases solely to negative, if possible, a determination that the intent of the parties was to provide for parity of distribution. The New York courts, having established a so-called "equitable" rule of distribution, look to the agreement solely to determine whether it contains

> "very clear and unambiguous language * * * to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid, remained unpaid. Such an inequitable result could be

> accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail" (*Pink v. Thomas, supra,* 282 N. Y. at p. 13, 24 N. E. [2d] at p. 725).

The rule, so stated, constitutes a rule of distribution rather than one of contract construction. (1941) 51 Yale L. J. 315, 317, 318; (1941) 51 Harv. L. Rev. 283, 284.

Respondent also apparently concludes that the debtor-creditor relationship arising solely from the making of the agreement of guaranty estops petitioner from obtaining parity. The only authorities cited by respondent in support of that conclusion are the New York decisions which refer to the debtor-creditor relationship as establishing a "special equity" justifying the application of an "equitable" rule of distribution. None of the opinions quoted by respondent speaks in terms of estoppel nor has respondent by reference to any other facts demonstrated the application of that theory to the instant case.

As above indicated, the debtor-creditor relationship is utilized by the New York courts solely to permit it to apply a rule of distribution which prefers the holder of the guaranteed certificate as against the guarantor's remaining creditors. But such debtor-creditor relationship existing between the Zo-Gale certificate holders and Prudence was no different than that existing between Prudence nd the holders of certificates in other issues which were also guaranteed by Prudence. Upon the reorganization of Prudence and the transfer of its assets to petitioner for the purpose of liquidation solely for the benefit of all of its creditors, the so-called "special equity", upon which the New York courts have relied, disappears and their rights by reason of the guaranty are now measured by their rights against The Prudence Company, Inc., as compared with the rights of all of the other Prudence creditors. The equities require that all holders of Prudence guaranties receive equal treatment. This can only

be accomplished by refusing priority to the publicly-held certificates. Thus, no basis whatsoever for any estoppel has been shown.

II

Respondent in Point II of his brief merely reasserts his position that the decision of this Court in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, requires the bankruptcy court to follow the New York decisions on the parity question. In referring to the opinion in that case as authority for his position, respondent fails to recognize the fact that the Bankruptcy Act is an Act of Congress. The portion of the opinion quoted by respondent at page 24 of his brief reads:

> "*Except in matters governed by the Federal Constitution or by Acts of Congress,* the law to be applied is the law of the State."

No effort has been made to refute the authority of *City of New York* v. *Feiring*, 313 U. S. 283, 61 S. Ct. 1028, 85 L. Ed. 1313, nor of *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 54 S. Ct. 695, 78 L. Ed. 1230, cited at pages 11 and 20, respectively, of petitioner's main brief. These two cases illustrate clearly that the administration of the Bankruptcy Act is controlled by the provisions of that statute and the decisions of the federal courts, not by the local law.

Citation of *Lerner Stores Corporation* v. *Electric Maid Bake Shops* (C. C. A., 5), 24 F. (2d) 780; *In re Knox-Powell-Stockton Co.* (C. C. A., 9), 100 F. (2d) 979; and *General Motors Acceptance Corporation* v. *Caller* (C. C. A., 6), 106 F. (2d) 584, at page 27 of respondent's brief, adds nothing to his argument in the instant case. These cases do no more than establish that the state law is controlling on the validity and extent of *liens*. However, no lien question is presented here. Although respondent rejects petitioner's assertion that the New York court has held that the right of priority granted to certificate holders other than the guarantor is a priority in payment and not a

priority in the mortgage lien, respondent's quotation from petitioner's cited authority, *In the Matter of the New York Title & Mortgage Company,* 163 Misc. 318, 296 N. Y. S. 644, affirmed without opinion, 254 App. Div. 722, 4 N. Y. S. (2d) 1004, appearing at pages 23, 24 of respondent's brief, conclusively demonstrates the validity of petitioner's conclusion. There the court held that although subordinate in payment, the guarantor's interest could not be considered the equivalent of a second mortgage, and therefore could not be cut off by foreclosure.

Moreover, by reference to the lien cases, and his consideration of the rights of other Prudence creditors as involving an "alien question", respondent has demonstrated his failure to appreciate the question here in issue.

Petitioner, in asserting its right to parity here for the benefit of all Prudence creditors, is not relying solely on the fact of the bankruptcy reorganization of the Zo-Gale certificate issue as making inapplicable the New York decisions. Petitioner, in its main brief, has illustrated that respondent's claim to priority in the distribution of the proceeds of the Zo-Gale mortgage is founded upon and measured by the guaranty obligation; that its effect, if successful, is to provide respondent with a right to collect upon that guaranty obligation without having submitted that additional right to collection for adjudication in the Prudence proceeding in which the guaranty obligation was being reorganized. The arguments advanced by petitioner in Point IV of its main brief, and the authorities there cited, have neither been considered nor answered by respondent. Had petitioner's views been given consideration it would appear clear that even if the federal bankruptcy court were bound to follow state court interpretations of contracts or liens, the obligation remains the creditor's to assert such claims in the bankruptcy forum, in this instance in the Prudence proceeding, or to be bound by the provisions of a plan of reorganization which limited collections on the guaranty obligation. *Black* v. *Richfield Oil Corporation* (D. C. S. D. Cal.), 41 F. Supp. 988.

To illustrate, where a mortgagee, and therefore a secured claimant, files a claim in a bankruptcy proceeding as an unsecured creditor, even though the binding state law gives him the status of a secured creditor, the bankruptcy court will hold that he has waived his right to the security and may participate in the distribution of the bankrupt estate solely as an unsecured creditor. *In re O'Gara Coal Co.* (C. C. A., 7), 12 F. (2d) 426; *In re H. Herrmann Furniture Co.* (U. S. D. C., S. D. N. Y., 1937) (Coxe, D. J.), C. C. H. Dec., par. 4473. In such case the state court determination of the creditor's right to a lien position is immaterial, because the distributive rights of the bankrupt's creditors are established by their asserted claims against the bankrupt, and the creditor's failure to take the benefit of the state law in asserting his claims is deemed a waiver *under the Bankruptcy Act.*

Similarly, in the instant case, at no time did the Zo-Gale certificate holders as guaranty creditors assert special contract rights in the Prudence proceeding which would warrant their being awarded a special status in the distribution of the Prudence assets in payment or adjustment of the guaranty obligation. To that extent, the question as to whether the New York law is applicable becomes academic. Its applicability in any case would be conditioned upon the creditor's formal proof of claim or upon claims thereafter asserted in the course of the Prudence reorganization. Having accepted unequivocally the benefits of the Prudence plan, and having consented to its provisions limiting the enforcement of the original guaranty obligation, the Zo Gale creditors may not now in the Zo-Gale proceeding disregard such limitations and secure additional rights of collection at the expense of other Prudence guaranty creditors.

The Prudence plan provides for a transfer of all of the Prudence assets to petitioner for the benefit of the Prudence creditors. The plan also provides that the assets are received by petitioner subject only to the requirement that payments be made to creditors *in accordance with the plan.*

The guaranty claims, *qua* guaranty claims, are extinguished and are replaced by the obligation on the part of petitioner to distribute to holders of such claims the proceeds of the liquidation of the Prudence assets in accordance with the provisions of the Prudence plan. The original guaranty creditors of Prudence, therefore, are not guaranty creditors of petitioner, but have been converted into beneficiaries of a liquidating trust, with a right to share in the distribution of its proceeds in accordance with the provisions of the plan.

In view of the insolvency of Prudence, the plan of reorganization, proposed by Reconstruction Finance Corporation and accepted by the Prudence creditors, was an agreement, not between the creditors and the debtor, but between the creditors alone, that all of their claims, based upon the guaranty or other obligations of the debtor, were to be adjusted by the distribution of all of the insolvent's assets among the creditors in the manner and in accordance with the formula set forth in the plan. There was no provision for collections on the guaranty obligation in addition to those provided in the plan.

The certificates and the guaranty did not constitute one, inseparable obligation. The certificate represented an undivided interest in a mortgage constituting a lien on real estate and constituted its holder the owner of an aliquot portion of the mortgage debt, and no more. The guaranty was the separate obligation of Prudence that the principal and interest of the certificate would be paid, but did not enlarge or otherwise affect the certificate holder's interest in the mortgage. The guaranty obligation could be released or satisfied without affecting the mortgage lien. Had the guaranty obligation been discharged by an outright release, respondent's right to make further collection on the guaranty would be barred. *Stoll* v. *Gottlieb*, 305 U. S. 165, 59 S. Ct. 134, 83 L. Ed. 104. Where, as here, it has been extinguished by the acceptance of the *quid pro quo* provided for in the Prudence plan, additional collection upon the guaranty obligation is similarly barred.

On page 4 of respondent's brief he urges that the question of parity was reserved in the Prudence plan, and in support of that argument he quotes a portion of Article IV, paragraph 2(a) of the plan. Although in the manner quoted by respondent the plan seems to provide affirmatively that Prudence-held certificates are to be deemed to be subordinate to certificates held by others, that effect is achieved only by respondent's omission of the preliminary phrase which modifies the entire provision of the plan. As properly quoted, paragraph 2(a) appears in the plan as follows:

> "2. (a). *If in the judgment of the Board of Directors* no definitive proration should be made of the value of the Collateral or other security for a particular certificate issue, due to uncertainty whether certificates of such issue held in the Debtor's estate on the Effective Date are on a parity with other certificates of such issue, the deduction to be made pursuant to the foregoing clause (1) shall be based in the first instance on the assumption that the certificates so held in the Debtor's estate are not entitled to parity, and an appropriate reserve shall be established by the New Company to provide for the additional distribution to be made to certificate holders of such issue if the Board of Directors shall be later satisfied that such parity exists; the Board of Directors being authorized to discontinue such reserve if and when satisfied that such parity does not exist;" (R. 82). (Italics supplied.)

The italicized portion of the above quotation, which was omitted by respondent, demonstrates clearly that there was no intention to reserve the question nor to provide for a method of distribution by specific provision of the plan, but that the provision was inserted merely as an administrative guide to be applied and adopted if, solely in the judgment of the Board of Directors of the New Company, the question of parity remained open for consideration. Certainly if it was the intention of the parties to the Prudence plan that the question of parity remain unaffected by the fact of the Prudence reorganization for the benefit of its creditors, and the further fact that no priorities in

the distribution of the Prudence assets were ever claimed or asserted in the Prudence proceeding by the Zo-Gale certificate holders, definite provisions could have been written into the plan to assure that result.

No effort has been made by respondent to overcome the effect of the provisions of the order approving the Prudence plan, which provides that there shall be no priority except for the payment of the claims of the United States Government and the State of New York for taxes and administration expenses (R. 107).

Respondent's reference to the District Judge's determination that the question of parity was at all times reserved is of no assistance. The District Court in reaching its conclusion cited no provisions of either the Zo-Gale or Prudence plans or orders of confirmation which justified the arbitrary conclusion that the question had been reserved (R. 124). Nor did the majority of the Circuit Court of Appeals which affirmed the District Court place any reliance on the reservation clauses referred to by respondent, except to reach the conclusion that such reservation in the Zo-Gale order of confirmation placed the remaining Prudence creditors represented by petitioner on notice of the fact that the question of parity was reserved (122 F. [2d] at p. 507). The conclusion by the majority of the Circuit Court of Appeals that such reservation had the effect of constituting petitioner, as creditors' representative, a purchaser with notice was considered and rejected by Judge Frank dissenting below (122 F. [2d] at p. 508) and has been referred to in petitioner's main brief at page 26.

III

Respondent has attempted to confuse the issues presented in the instant case by asserting that arguments, made by petitioner to support its position that its uncertificated interest in the Zo-Gale mortgage is entitled to parity, have

also been urged by it to justify granting parity on the issued certificates which it holds (Respondent's Brief, p. 18). Petitioner has distinguished the two situations and has dealt separately with them in its main brief (Point V).

Again, at page 19 of his brief, respondent asserts that petitioner has argued that since Reconstruction Finance Corporation owns the stock of Amalgamated Properties, Inc., which it had previously accepted as security for a loan to Prudence, petitioner's certificates are entitled to parity. As is apparent from the clear language in petitioner's main brief, at page 25, reference to the Reconstruction Finance Corporation's ownership of Amalgamated Properties, Inc., was to refute the unsupported statement by the majority of the Circuit Court of Appeals that all that was involved here was a consideration of mutual claims of inter-related companies.

Respondent, however, misstating petitioner's position, asserts that the pledge does not result in the creation of a right to parity, citing *Matter of Lawyers Title & Guaranty Co.*, 287 N. Y. 264, as authority. Since petitioner has never relied on the pledge of the Amalgamated stock with Reconstruction Finance Corporation as the basis for its claim to parity, the cited authority does not refute petitioner's arguments. However, a reading of the opinion in that case demonstrates the extent to which the New York rule has carried the court. In that connection it is interesting to note that Chief Judge Lehman of the New York Court of Appeals, who either wrote or concurred in the prevailing opinions in prior cases holding the guarantor's certificates to be subordinate, dissented in the latest decision, without opinion.

Moreover, the decision in *Matter of Lawyers Title & Guaranty Co., supra*, serves to demonstrate the effect of the opinion of the majority of the Circuit Court of Appeals in the instant case that similar treatment should be accorded certificate holders without regard to the forum in which the liquidation occurs (122 F. [2d] at p. 507). If such similarity of treatment is made mandatory by an

affirmance in the instant case, the federal bankruptcy court administering the estate of a corporation which has issued the identical certificate with the same guaranty in the states of New York, Pennsylvania and New Jersey will be required to apply the local law and to decide distributive rights of creditors in the following manner: Where certificates have been repurchased by the guarantor and retained by it, those issued in New York and Pennsylvania must be subordinated (*Pink* v. *Thomas, supra; Agricultural Trust & Savings Company's Mortgage Pool* case, 329 Pa. 581, 198 Atl. 16) and those issued in New Jersey are entitled to parity (*Kelly* v. *Middlesex Title Guarantee and Trust Co.*, 115 N. J. Eq. 592, 171 Atl. 823 [Chancery], affirmed on this opinion by the New Jersey Court of Errors and Appeals in 116 N. J. Eq. 574, 174 Atl. 706): where such certificates have been pledged by the guarantor to a foreign corporation, those issued in New York are to be subordinated (*Matter of Lawyers Title & Guaranty Co., supra*) and those issued in Pennsylvania and New Jersey are entitled to parity (*Land Title Bank & Trust Co.* v. *Schenck*, 335 Pa. 419, 6 Atl. [2d] 878; *Kelly* v. *Middlesex Title Guarantee and Trust Co., supra*).

Under the circumstances outlined, it is submitted that where the similarity of treatment required by the decision of the majority of the Circuit Court of Appeals in the instant case is made mandatory upon the bankruptcy court the uniformity in bankruptcy legislation and administration required by the United States Constitution, Article I, Section 8, no longer can exist. Petitioner respectfully submits that the constitutional mandate for uniformity takes precedence over the views expressed by the majority in the instant case.

IV

There can be no doubt that any subordination in bankruptcy of claims having the same economic status as other claims is to be determined by the bankruptcy court upon

consideration of the merits of each particular case. In its main brief, petitioner has demonstrated that the decision of this Court in *Erie R. Co.* v. *Tompkins, supra,* does not require the federal bankruptcy court to apply state court decisions establishing rules of distribution in state insolvency proceedings and, as above indicated, there is nothing in respondent's brief showing the contrary. It is submitted that in the bankruptcy court, subordination of some of the claims of the same economic class will not be decreed unless compelling equities are present which justify such subordination. Respondent has wholly failed to show that such equities exist in his favor but, on the contrary, it appears that it would be inequitable under the circumstances in the instant case to permit the other holders of Zo-Gale certificates, after having proved their claims in the Prudence reorganization proceeding for the full face amount of the guaranty, to syphon away a portion of the Prudence assets by allowing priority in the Zo-Gale proceeding.

As has heretofore been demonstrated, Prudence was engaged in the business of making guaranties similar to the one involved in the instant case and at the time of its reorganization many thousands of such guaranties were outstanding. In addition, Prudence dealt in bonds and certificates of issues which it had guaranteed and it was only by fortuitous circumstances that upon the date of its petition in the bankruptcy proceeding Prudence held in its portfolio certificates of any particular issue rather than similar securities in other issues which it had guarantied. Such certificates were general assets upon which all holders of Prudence guaranties relied in making their investments and were considered part of the assets available for the payment of the guaranty obligation. Under such circumstances it would seem to be highly inequitable to permit the Zo-Gale certificate holders in effect to obtain a higher return upon the guaranties held by them than that received by the holders of other Prudence guaranties,

merely because at the time of its bankruptcy Prudence held some of the Zo-Gale certificates.

In its main brief, petitioner has referred to the fact that the guaranty creditors in state insolvency proceedings are deemed secured creditors, as contrasted with their status as unsecured creditors under the Bankruptcy Act; that under the state insolvency laws, where subordination of the guarantor's interest is determined by the New York court, the guaranty creditor is required to deduct the value of the guarantor's interest as well as the value of his own security from his claim against the remaining assets of the insolvent guarantor, and that under the Bankruptcy Act no equivalent credit is given to the insolvent estate in the event of a determination of subordination. Therefore, what might be considered an equitable result under the state insolvency statutes appears to be highly inequitable when applied to a case arising under the Bankruptcy Act.

V

Under all of the circumstances in the instant case petitioner respectfully submits that the decision of the Circuit Court of Appeals for the Second Circuit should be reversed.

Respectfully submitted,

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